No. 22730

United States
Court of Appeals
for the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

v.

DOROTHY C. REGAN,

Appellee.

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

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INDEX

CITATIONS

CASES CITED

STATUTES

STATUTES (cont.)

MISCELLANEOUS

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OPINION BELOW

The memorandum opinion (I-R. 19-20) of the District Court is not officially reported.

JURISDICTION

This appeal involves federal income taxes for the calendar years 1960, 1961, and 1962 in the total amount of $148.70, plus interest. (I-R. 21-22.) The assessed deficiencies were paid by the taxpayer. (I-R. 25.) Claims for refund were timely filed on June 7, 1966, with the District Director in Portland, Oregon. (I-R. 7-9.) Within the time provided by Section 6532 of the Internal Revenue Code of 1954, on November 18, 1966, the taxpayer brought this action in the District Court for recovery of the taxes paid. (I-R. 1-9.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346(a)(1). The judgment of the District Court was entered on November 6, 1967. (I-R. 21-22.) The notice of appeal was filed within sixty days thereafter, on January 4, 1968. (I-R. 28.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

As joint venturers, taxpayer and others acquired timber-cutting rights, constructed access roads to the timber stand at their own expense, and transferred the cutting rights in a transaction qualifying for capital gain treatment under Section 631(b) of the Internal Revenue Code of 1954. The question is whether taxpayer's share of the cost of the access

roads is deductible as business expense from ordinary income, as taxpayer contends and the District Court held, or is recoverable only by way of offset in the Section 631(b) computations of capital gain from the transaction, as the Government contends.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statute and other authorities involved are set forth in the Appendix, *infra*.

STATEMENT

The material facts, as found by the District Court (I-R. 23-25) and reflected in the agreements stipulated into evidence (Pltf. Exs. 1, 2 and 3), may be summarized as follows:

In April, 1960, taxpayer joined with others in a joint venture (hereinafter "Idapine Tenants"). They purchased, as tenants-in-common, the assets of a partnership in the lumbering business. These assets included logging equipment, lumber manufacturing and remanufacturing plants, and all of the capital stock of Idapine Mills, Inc., an Oregon corporation. The operating equipment was then leased to the corporation. Taxpayer had a one per cent interest in the joint venture. (Pltf. Ex. 1, pp. 1, 3.)

Under a contract with the Forest Service, Idapine Tenants acquired the right to cut merchantable timber on certain Government lands at specificed stumpage rates of payment per thousand board feet cut and removed. Idapine Tenants agreed to construct the access roads to the timber stand. If the Forest Service had constructed the roads, amounts reflecting amortization of the cost would have been added to the stumpage rates payable by Idapine Tenants. (Pltf. Ex. 3, pp. 1-4, 7(1), Sec. 7f.1.)

Idapine Tenants constructed the access roads (I-R. 24) and transferred its cutting rights to Idapine Mills, Inc., its wholly-owned operating company, in consideration of specified stumpage payments per thousand board feet cut and removed. (Pltf. Ex. 2, pp. 1-2 and Ex. B).[1]

During the taxable years, the members of the joint venture, including taxpayer, amortized the cost of the access roads on the basis of the quantity of timber sold. In her returns, taxpayer deducted her proportionate share of the road amortization as ordinary and necessary business expense.

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[1] The agreements in evidence between the Forest Service and Idapine Tenants and between Idapine Tenants and Idapine Mills, Inc., are not the actual agreements involved, but were jointly offered in evidence as representative in their terms of the actual agreements. (II-R. 15-16.)

The Commissioner disallowed these deductions, determining that the cost of the roads was part of the cost of the timber sold by the joint venture during the taxable years. Taxpayer paid the deficiencies assessed, filed timely claims for refund and, on their disallowance, commenced the instant litigation. (I-R. 24-25.)

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court erred in holding that the costs of the access roads, as amortized, were deductible from income as ordinary business expense.

2. The District Court erred in failing to hold that the costs of the roads were part of the costs to the joint venture of the timber, and recoverable only by way of offset in the Section 631 (b) computations of capital gain from the joint venture's transaction with the corporation.

SUMMARY OF ARGUMENT

Taxpayer and others were members of a joint venture, Idapine Tenants, which acquired rights to cut timber on Government land. They constructed access roads to the timber stand at their own expense and transferred the cutting rights to their wholly owned corporation in consideration of pay-

ments geared to and dependent upon the cutting and removal of the timber. The transaction with the corporation qualified for capital gain treatment as a "disposal" of timber, under Section 631(b) of the 1954 Code, the gain being computed by offsetting Idapine Tenants' "adjusted depletion basis" against the gross proceeds, i.e., the payments from the corporation. Under relevant statutory and regulatory provisions, the joint venture's "adjusted depletion basis" was its adjusted cost basis in the timber (or timber cutting rights), and that basis had to be amortized and offset ratably against the payments from the corporation in computing capital gain.

Idapine Tenants capitalized and amortized the costs of the access roads — but the District Court held that they were entitled to deduct the costs, as amortized, as ordinary and necessary business expense. This was error. The costs of the roads were incurred to produce, and were an integral part of, the transaction treated by Section 631(b) as a completed sale yielding capital gain. They were thus a part of Idapine Tenants' adjusted cost basis and recoverable only by way of offset in the Section 631(b) computations of capital gain. This result is required by the statutory and regulatory scheme and by relevant decisions. The cases cited by the District Court in support of its ruling are not in point.

ARGUMENT

THE JOINT VENTURE'S COSTS OF CONSTRUCTING ACCESS ROADS TO THE TIMBER WERE RECOVERABLE ONLY BY WAY OF OFFSET IN THE COMPUTATIONS OF CAPITAL GAIN UNDER SECTION 631(b)

1. *The requirements of Section* 631(b) *in the context of pertinent statutory and regulatory provisions, and legislative history.*

Section 631(b) of the Internal Revenue Code of 1954, Appendix, *infra,* accords preferential capital gain treatment in the case of certain timber transactions. It provides in pertinent part that:

> In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or a loss, as the case may be, on the sale of such timber.

The term "owner" is defined in Section 631(b) as "any person who owns an interest in such timber, including * * * a holder of a contract to cut timber." Such an "owner" retains an "economic interest" in timber, while effecting its "disposal," where he transfers cutting rights in consideration of

payments geared to and dependent upon the cutting and removal of the timber.[2]

It is undisputed in this litigation that the transfer of cutting rights from Idapine Tenants, the joint venture, to Idapine Mills, Inc., its wholly owned operating company, was a "disposal of timber by the "owner" within the purview of Section 631(b). The joint venture retained an "economic interest" since the transfer was in consideration of unit payments for timber when and as cut and removed. (Pltf. Ex. 2, pp. 1-2, Ex. B.) Hence these payments, as received by Idapine Tenants, were to be treated under Section 631(b) as the gross proceeds of a capital transaction. The question is whether the cost of the access roads was includible in Idapine Tenants' "adjusted depletion basis" which, under Section 631(b), must be offset against the gross proceeds in computing Idapine Tenants' capital gain.

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[2] See the definition of an "economic interest" for depletion purposes in Treasury Regulations on Income Tax (1954 Code), Section 1.611-1(b)(1). The capital nature of the gain in such transactions is reflected in the language employed in Section 631(b) ("shall be considered as though it were a gain * * * on the sale * * *") and confirmed by cross-reference in the capital transaction provisions of Section 1231(b)(2) of the 1954 Code. Section 631(a) accords similar capital gain treatment, on timely election, to the taxpayer who acquires the cutting rights and harvests the timber.

At the outset, it should be noted that Section 631(b) is not an isolated and self-contained statute. To be sure, it is special legislation. It was originally added to the 1939 Internal Revenue Code, as Section 117(k)(2), by Section 127(a) of the Revenue Act of 1943, c. 63, 58 Stat. 21, and the underlying legislative history makes it clear that "owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest" are to be treated as on the same footing, for tax purposes, as taxpayers who sell timber stands outright. S. Rep. No. 627, 78th Cong., 1st Sess., p. 25 (1944 Cum. Bull. 973, 993)[3] Section 631 (b) is nevertheless a provision within the depletion context, and its use of the term "adjusted depletion basis" (as its use of the term "economic interest") can only be understood in that context.

Section 611(a) of the 1954 Code, Appendix, *infra*, authorizes a "reasonable allowance for depletion" in the case of timber and natural deposits, such allowance to be made "in all cases * * * under regulations prescribed by the Secretary or his delegate." Section 612, Appendix, *infra*, requires that the basis on which depletion is to be allowed, except as otherwise provided, "shall be the adjusted basis

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[3] See Rowen, Taxation of Income from Timber Properties, 33 Taxes 336 (1955).

provided in Section 1011 for the purpose of determining the gain upon the sale or other disposition of such property," i.e., the timber or the natural deposit. Section 613 of the Code, which authorizes percentage depletion, makes no provision for such depletion in the case of timber. Hence, as set forth in Treasury Regulations under Section 612,[4] the adjusted depletion basis for timber "is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis * * *".

No basis for depletion other than cost is authorized in the instant case, under the terms of Section 1012, Appendix, *infra,* and none of the adjustments to basis required by Section 1016 is pertinent save for the general requirement of Section 1016(a)(1). Appendix, *infra*, that proper adjustments shall be made "for expenditures, receipts, losses, or other items, properly chargeable to capital account * * *."

In sum, the "adjusted depletion basis" for timber, referred to in Section 631(b), is Idapine Tenants'

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[4] Treasury Regulations on Income Tax (1954 Code), Section 1.162-1 (a), Appendix, *infra*. There is no discrepancy between the reference therein to Section 1012 of the Code, Appendix, *infra,* and the reference in Section 612 to Section 1011, Appendix, *infra,* since Section 1011 refers in turn to Section 1012. The special rules for adjusting the cost depletion basis of timber as set forth in Section 1.612-1 (b) of the above-cited Treasury Regulations, Appendix, *infra,* are inapplicable here.

cost basis as adjusted for expenditures and other items properly chargeable to the capital account. It is this adjusted cost basis which must be offset against the gross proceeds ("the amount realized from the disposal of such timber") which Idapine Tenants received from Idapine Mills, Inc., in consideration of the transfer of the cutting rights.

Since the gross proceeds under the instant cutting contract are payments geared to the cutting and removal of the timber, it follows logically that Idapine's adjusted cost basis should be amortized and offset ratably against the payments received from the corporation, over the estimated period required for completion of the harvest. And this is precisely what is required by the pertinent provisions of Treasury Regulations on Income Tax (1954 Code). Section 1.631-2, Appendix, *infra*, relating to the Section 631(b) computation, provides that the "adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion." Section 1.611-3(a), Appendix, *infra*, provides that in the case of timber "the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder." And Section 1.612-1(a), Appendix, *infra*, relating to cost basis depletion under Section 612 of the Code, provides that: "In the case of the sale of

a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained".[5]

Thus, it is clear that Idapine Tenants' adjusted cost basis in the timber, as computed for cost depletion purposes, had to be amortized and offset ratably against the payments received in the capital gain computations prescribed by Section 631(b).

> 2. *The joint venture's costs of constructing the access roads were part of their adjusted cost basis and, as such, includible in the Section 631(b) capital gain computations.*

Taxpayer agrees with the Government that the costs of the access roads had to be capitalized at the outset and states that these costs were, in fact, so capitalized. (II-R. 12.) The District Court found that the joint venture amortized these costs on the basis of timber quantities. (I-R. 24.) As taxpayer states (II-R. 12), they "amortized the cost of those logging roads over the life that we brought in the income", i.e., the payments from the corporation for

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[5] More explicitly, Section 1.611-3(b) (2) provides that the "depletion unit" for timber in a given year is the cost basis divided by the number of timber units, with adjustments to basis for the cost of timber acquired during the year "plus proper additions to capital", and adjustments to the number of timber units "by way of correcting the estimate of the number of units remaining available in the account".

timber cut and removed. Nevertheless, taxpayer contends (II-R. 12) that the costs of the roads were "an ordinary and necessary expense of carrying on the sale" of the timber to the corporation; that they were "in the business of selling timber", and therefore entitled to deduct the road costs, as amortized, as ordinary and necessary business expenses.

We submit that the District Court clearly erred in sustaining taxpayer's contentions. Idapine Tenants were entitled to capital gain treatment under Section 631(b) only because, by virtue of that provision, their transfer of cutting rights to the corporation was treated as a completed sale in consideration of deferred payments — a "disposal" of timber under a contract reserving to them an "economic interest" in the form of payments geared to harvesting. The agreement transferring cutting rights cannot, at one and the same time, be treated as a completed capital transaction with respect to some of the costs incurred to produce it, and a mere executory arrangement to make continuing sales in the course of a trade or business with respect to other costs of the same nature.

The costs to Idapine Tenants of constructing the access roads were, quite obviously, as much a part of the joint venture's adjusted cost of depletion basis in the timber (or timber cutting rights) as the pay-

ments to be made to the Forest Service. Under Idapine Tenants' contract with the Forest Service, the payments to the latter would have been augmented by the amount of the road costs, as amortized, if the Forest Service had built the roads. (Pltf. Ex. 3, pp. 1-4.) The road costs were no less a part of the joint venture's adjusted cost basis, when borne directly by the joint venture. Under Section 1016(a)(1) of the Code, Appendix, *infra*, the road costs were expenditures properly chargeable to the capital account involved. They were incurred to produce the capital gain from the "disposal" of the timber, and cannot be severed from the transaction or the Section 631(b) computations.

Indeed, the Treasury Regulations under Section 631(b) explicitly provide that amounts paid in the acquisition of timber or timber cutting rights, however designated, shall be treated as the cost of the timber and shall constitute part of the taxpayer's basis for the purposes of Section 631(b).[6] Idapine Tenants' costs of constructing access roads, which were essential to the exercise of the cutting rights, were surely integral to the acquisition and "disposal" of such rights. They were "direct expenses incurred in connection with the disposal of * * * timber",

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[6] Treasury Regulations on Income Tax (1954 Code), Section 1.631-2(e)(1), Appendix, *infra*.

and, accordingly, includible in the Section 631(b) computation — not deductible from ordinary income. Rev. Rul. 58-266, 1958-1 Cum. Bull. 520, 523, Appendix, *infra*, p. 17.

As this Court said in *Spangler v. Commissioner*, 323 F. 2d 913, 921:

> Costs connected with disposition of a capital asset are also capital expenditures to be added to taxpayer's basis, or offset against the sales price, rather than expenses deductible from ordinary income.

Accord, *Ward v. Commissioner*, 224 F. 2d 547, 555 (C.A. 9th, 1955); *United States v. Morton*, 387 F. 2d 441, 449-450 (C.A. 8th, 1968); *Alphaco, Inc. v. Nelson*, 385 F. 2d 244, 245 (C.A. 7th, 1967); *Munson v. McGinnes*, 283 F. 2d 333, 335-337 (C.A. 3d, 1960), certiorari denied, 364 U.S. 880 (1960); *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373, 378 (C. Cls. 1960).

As noted above, Congress enacted the predecessor of Section 631(b) in order to put taxpayers who acquire and assign cutting rights, reserving an "economic interest", on an equal footing for tax purposes with timber owners who sell their timber stands outright. If a timber owner constructs access roads and then sells his timber stand, the road costs would

obviously be part of his basis for the purpose of the capital gain computation. Congress could scarcely have intended to confer even greater tax benefits on taxpayers effecting Section 631(b) transactions, by allowing them to expense the road costs against ordinary income.

In support of its decision, the District Court cites *Converse v. Earle* (D. Ore.), decided August 9, 1951 (43 A.F.T.R. 1308), as a case "directly in point", and quotes general language from *Union Bag-Camp Paper Corp. v. United States,* 325 F. 2d 730 (Ct. Cl.). The court's reliance is misplaced.

It appears from the relevant findings in *Converse* (43 A.F.T.R. p. 1310) that the taxpayer did not claim capital gain treatment of his timber income but, rather, reported it as ordinary income from a trade or business. Hence, the ruling that the taxpayer was entitled to expense the costs of access roads is irrelevant to the treatment of such costs in a capital gain computation under Section 631(b). Moreover, if the taxpayer in that case owned the land on which the access roads were constructed, the decision is simply wrong; a taxpayer's costs of effecting permanent improvements or betterments to property he owns are, with irrelevant exceptions, capital expenditures which are non-deductible by statute. See Section 263(a) of the 1954 Code.

Nor is *Union Bag-Camp Paper Corp.* in point. In holding there that the taxpayer's management expenses could be expensed, the court said that (325 F. 2d p. 742, fn. 26) "plaintiff's forest management expenses were incurred primarily in the ordinary conduct of its business, and the record discloses no recognizable part of such expenses to be directly related to timber sales under cutting contracts".

In the case at bar, the costs of constructing the access roads were indeed "directly related" to the transaction and were incurred to produce the gain treated as capital under Section 631(b). Accordingly, Idapine Tenants properly capitalized and amortized those costs. But the costs were improperly expensed; they were part of the "adjusted depletion basis" which, under Section 631(b), were recoverable only by way of offset in the computation of capital gain.

CONCLUSION

For the reasons set forth above, the judgment of the District Court should be reversed.

Respectfully submitted,

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JUNE, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 12th day of June, 1968.

SIDNEY I. LEZAK
United States Attorney.

APPENDIX

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of * * * natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

* * * * *

(26 U.S.C. 1964 ed., Sec. 611.)

SEC. 612. BASIS FOR COST DEPLETION.

Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

(26 U.S.C. 1964 ed., Sec. 612.)

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

* * * * *

(b) *Disposal of Timber With a Retained Economic Interest.*—In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. * * * For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

* * * * *

(26 *U.S.C.* 1964 *ed.*, *Sec.* 631.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received

plus the fair market value of the property (other than money) received. * * *

* * * * *

(26 U.S.C. 1964 ed., Sec. 1001)

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

(26 U.S.C. 1964 ed., Sec. 1011.)

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

(26 U.S.C. 1964 ed., Sec. 1012.)

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, * * *

* * * * *

(26 U.S.C. 1964 ed., Sec. 1016.)

Treasury Regulations on Income Tax (1954 Code):

§1.611-3 *Rules applicable to timber.*

(a) *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. * * *

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. * * *

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on

hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. * * *

* * * * *

(c) *Timber depletion accounts on books.*

(1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. * * *

* * * * *

(26 C.F.R., Sec. 1.611-3.)

§1.612-1 *Basis for allowance of cost depletion*

(a) *In general.* The basis upon which the deduction for cost depletion under Section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations.

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purpurposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include explora-

tion or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612-4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

* * * * *

(26 C.F.R., Sec. 1.612-1)

§1.631-2 *Gain or loss upon the disposal of timber under cutting contract.*

(a) *In general.* (1) If an owner disposes of timber held for more than six months before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. * * *

* * * * *

(e) *Other rules for application of section.*

(1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

* * * * *

(26 C.F.R., Sec. 1.631-2.)

Rev. Rul. 58-266, 1958-1 Cum. Bull. 520:

* * * * *

Advice has been requested as to the Federal income tax treatment of expenditures which are directly attributable to the disposal of coal or timber under the provisions of section 117(k) (2) of the Internal Revenue Code of 1939.

The taxpayer in this case is a corporation which is the owner and lessor of coal lands. Substantially all of its income is derived from the disposal of coal within the purview of section 117 (k) (2) of the Code. In connection with and directly attributable to the disposal of coal so as to produce the maximum income therefrom, the taxpayer expends substantial amounts for checking the lessee's records for

accounting and billing purposes, for mining engineers to insure that the maximum amount of coal will be mined by modern methods, for supervisory safety measures, etc.

Section 117(k) (2) of the Code, as amended by the Revenue Act of 1951, 65 Stat. 452, 26 U.S.C. 117, provides, in part, as follows:

> In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the *amount received* for such timber or coal and the adjusted basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided for in section 114 (b) (4) with respect to such coal. * * * (Italics supplied.

The specific question, therefore, is whether the words "amount received," as used in section 117(k) (2) of the Code mean the gross amount received or whether these words are to be interpreted to mean the gross amount reduced by the direct expenses incident to the transaction.

Section 117(k) (2) of the Code was originally added to the Code by section 127(a) of the Revenue Act of 1943, C.B. 1944, 756 at 773, and, as enacted at that time, was applicable only with respect to the disposal of timber.

Senate Report No. 627, 78th Cong., First Session, C.B. 1944, 973 at 993, on the Revenue Act of 1943 states:

> Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess profits tax laws. The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profits tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are therefore not accorded under present law capital-gain treatment of any increase in value realized over the depletion basis.

It is apparent that, in the above statement, a comparison was being made of economic income from sale versus economic income from cutting or lease. The impact of income tax upon a taxpayer deriving income from cutting or lease discriminated against such taxpayer as compared with the impact of the lower capital gain rate applicable to a taxpayer deriving income from a sale.

It has been the consistent position of the Internal Revenue Service, in connection with transactions qualifying for capital gain or loss treatment, that selling expenses are treated as an offset to the selling price. I. T. 2305, C.B. V-2, 108 (1926); (*Mrs.*) *E. A. Griffin v. Commissioner*, 19 B. T. A. 1243; *Therese C. Johnson v. Commissioner*, 7 T. C. 465, acquiescence C. B. 1946-2, 3. Since the selling expenses in a sale of a capital asset are considered in arriving at income subject to capital gain tax, it would seem reasonable to give like

consideration to direct expenses in connection with income from leases. In this way the comparison set forth in the above Committee Report would constitute a comparison of like concepts and afford a basis for a sound determination as to a finding of discrimination between similarly situated taxpayers. The fact that selling expenses may be of a recurring nature has been held not to affect their treatment as an adjustment to the selling price. *General Spring Corporation v. Commissioner,* Tax Court Memorandum Opinion, entered July 27, 1953.

Section 112(a) of the Code provides in general that, upon the sale or exchange of property, the entire amount of gain or loss determined under section 111 of the Code shall be recognized. Section 111 of the Code provides, in part:

> (a) Computation of Gain or Loss. — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

There is no essential difference between the words "amounts received" found in section 117(k)(2) of the Code and "money received" as used in section 111. Under section 117(k)(2) since the transaction is considered as though it were a gain or loss upon the sale of

such timber or coal, and under appropriate circumstances, as provided by section 117 (j), gain is considered as long-term capital gain, the direct expenses incident to the transaction should constitute a reduction of the "amount received" in the same manner that selling expenses reduce the sales price.

The words "amounts received" are found in section 117(f) of the Code. Section 117(f) of Code provides:

> Retirement of Bonds, Etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidence of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

The effect of this section is to convert ordinary income or loss to capital gain or loss, without any reference however to section 117 (j) of the Code. Section 117(f) has been a part of the Code since its enactment in 1939.

In the case of *Edward A. Atlas v. Commissioner*, Tax Court Memorandum Opinion, entered January 27, 1945, two of the questions in issue were whether the taxpayer realized taxable income in 1940 when he surrendered bonds purchased at a discount and whether the gain, if any, is taxable in part as a long-term capital gain. In accordance with the provisions of section 117(f) of the Code, the court held:

> We think that the surrender of the $61,000 bonds, Series M-1184, for the Fort Hubbard Apartments was the equivalent of the retirement of the bonds by the

Bankers Trust Co. The gain to the petitioner upon such transaction was the difference between the cost of the bonds, $23,430.77, and the stipulated fair market value of the Fort Hubbard Apartments received, $70,000, less the fees, commissions and expenses amounting to $1,795.50, or a net gain of $44,773.73.

"The amount of the gain attributable to each period is the difference between the cost of the bonds acquired in such period and an aliquot portion of the net amount received upon surrender of the bonds, 70,000 less $1,795.50, or $68,204.50."

In the case of a corporation deriving substantially all its income from coal or timber leases, to which section 117(k) (2) of the Code is applicable, the tax relief intended by the Congress in enacting this section would be largely lost if the direct expenses attributable to the lease were not considered in arriving at the gain which would be treated as long-term capital gain. Under such circumstances, the corporation would either derive no tax benefit from these expenses, if the alternative tax under section 117(c) (1) of the Code was applicable, or it would derive no tax benefit under section 117(k) (2) if its direct ex-expenses were so large as to make the alternative tax under section 117(c) (1) inapplicable.

On the other hand, in the case of a corporation realizing appreciable ordinary income, as well as income from section 117(k) (2) leases, if the direct expenses are not considered in arriving at the gain computed under this section, the gross profit from the lease (gross amount received less cost depletion) will be subject to a maximum tax at substantially lower long-term capital gain rates, whereas

the direct expenses will in turn offset the ordinary income subject to the higher corporate normal and surtax rates. There appears to be no basis for concluding that section 117(k) (2) was intended to operate in such a manner as to favor corporations deriving both ordinary income and section 117(k) (2) income as against corporations deriving only section 117(k) (2) income.

Accordingly, it is held that direct expenses incurred in connection with the disposal of coal or timber subject to the provisions of section 117(k) (2) of the Code reduce the amount received for the purpose of computing gain or loss from such disposal of coal or timber. Whether any expense is a "direct expense" is a matter to be determined largely on the strength or persuasiveness of the facts of each particular case and how closely related are the activities in connection with which the expense is incurred to the disposal of the coal or timber.